Investment Strategy Update

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Bond investors see inflation ahead, but they could be wrong

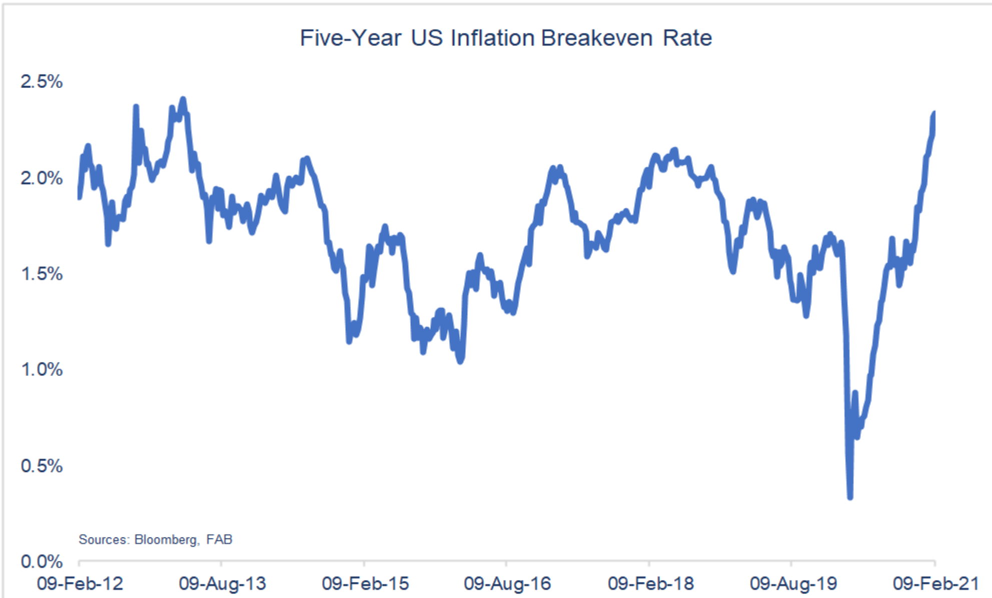
♦ The five-year inflation breakeven rate hit the highest since 2013 as investors weigh the prospects of more stimulus.

♦ The measure is closely watched by the Federal Reserve and the last time it was this high the Fed signalled at tapering its quantitative easing.

♦ This time, however, the Fed is likely to wait for actual inflation to stay above 2% for a while before moving.

♦ While forward breakeven inflation rates have been above the Fed's 2% target several times in the past decade, actual inflation has lagged.

♦ The FAB AAC is overweight in equities, IG and EM bonds, and gold, and is underweight alternatives.



Inflation is rearing its ugly head again. Or, at least, this is what bond investors seem to see in the future. Breakeven inflation rates traded at the highest in several years today, with five-year rate hitting 2.34%, a level last seen in March, 2013.

Breakeven rates are calculated by comparing the yield on conventional Treasury bonds and those that pay the inflation rate plus a premium. Historically, whenever the five-year breakeven rate held above 2%, the Federal Reserve signaled with monetary tightening ahead, sometimes causing risk assets to retreat.

However, Fed officials learned a painful lesson in 2013. Then, they signaled at monetary tightening after the breakeven rose above 2% for six months. The indication triggered the so-called 'taper tantrum' and slowed the economy.

The market reaction and its impact on the US economy have left Fed officials much more cautious about acting swiftly when breakeven rates start to indicate inflation may spike in a few years.

Fed officials have also learned that the breakeven rate is a blunt tool to predict the direction of inflation. In the past decade, the five-year breakeven rate has spent 30 months trading above the Fed's target of 2%. Meanwhile, the monthly core PCE inflation which the Fed targets, only went above 2% (and not by much) 11 times.

And even when inflation breached 2%, it was for brief periods. Plus, it happened shortly after the breakeven was above 2%, and not five years in the future. This may be because bond funds use inflation protected Treasuries to hedge current inflation, and hence skew the breakeven.

The Fed also changed its framework last year, so it can allow inflation to run above 2% for a while before it needs to act.

The five-year breakeven inflation rate has risen to 2.34%, its highest since 2013

Nonetheless, higher inflation breakeven rates can have knock-on effects that could temporarily shake risk assets. Many bond and mortgage funds use these rates in their models for future interest rates, based on the assumption that higher inflation will lead to higher interest rates.

Some funds might reduce the overall duration of their bond portfolio, or short long duration bonds to hedge against the risk of higher rates. Mortgage investors may also short long-dated Treasuries, as they expect fewer people to refinance their loans in the future. These moves may explain why 10- and 30-year US Treasury yields hit their highest in a year this week. With US unemployment this high, however, inflation seems a long way away.

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